

CONSEQUENCES OF DEBT EXCHANGES

INTRODUCTION

With U.S. corporate bankruptcies poised to hit a decade-long high as a result of the economic impact of COVID-19, we have prepared these materials that detail the key bankruptcy tax issues and guidance offered by Linda Swartz, the chair of Cadwalader's Tax Group, in old and new speeches and panels. We hope you find this presentation to be both useful and informative.

For additional information, contact [Linda Swartz](mailto:linda.swartz@cwt.com) (linda.swartz@cwt.com).

Upcoming speaking engagements:

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| October 14, 2020 | <ul style="list-style-type: none">• Linda Swartz will be presenting "Tax Strategies for Financially Troubled Businesses and Other Loss Companies" at PLI's Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2020 |
| November 5, 2020 | <ul style="list-style-type: none">• Linda Swartz will be presenting "A Cause for Distress? The Ways the Federal Income Tax Pushes Taxpayers into Bankruptcy" at The University of Chicago Tax Conference |
| January 25, 2021 | <ul style="list-style-type: none">• Linda Swartz will be presenting "Distressed Corporations: Creditor and Shareholder Issues" at the 2021 University of Southern California Federal Tax Institute |
| February 8, 2021 | <ul style="list-style-type: none">• Linda Swartz will be presenting "Workouts and Debt Restructurings" at PLI's 23rd Annual Real Estate Tax Forum |
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LINDA Z. SWARTZ



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Linda Swartz, the longtime chair of Cadwalader's Tax Group and member of the Firm's Management Committee, focuses her practice on structuring complex restructurings, bankruptcies, mergers and acquisitions, spin-offs, joint ventures, and foreign tax planning strategies. She also regularly advises clients on fund structures, financings and derivative transactions.

Linda is consistently recognized as one of the leading tax lawyers in the country. She was recently named one of 14 "Influential Women In Tax Law" by *Law360*, noted for her role as "a key architect on billion-dollar transactions involving major multinational companies" with clients describing her tax structuring expertise as "so strong that we don't even go to the IRS to get a blessing from them. We go to Linda to get a blessing from her." She has been described by *Chambers USA* as "acclaimed for her vast reservoir of practical knowledge of the U.S. tax code" and "an expert on the law of today but cognizant of where the law might go in the future, allowing clients to make decisions which last for the next ten years." Clients quoted by *The Best Lawyers in America* have described Linda as "the foremost U.S. tax advisor on structured acquisition and divestiture deals" and "a professional force of nature" with "extraordinary technical ability, coupled with fiercest and most trenchant deal negotiation skills of any transactional tax lawyer." She was also recognized as "2017 Foreign Tax Planning Lawyer of the Year" by *Finance Monthly*, and *Dow Jones*, reporting on Procter & Gamble's Reverse Morris Trust transaction with Coty, noted that "it isn't often you see a tax adviser credited on a deal, but that's exactly what happened for Cadwalader, Wickersham & Taft in P&G's complicated \$12.5 billion unloading of its beauty business to Coty."

Linda is widely regarded as a thought leader in the industry and is a prolific speaker and writer on a wide range of transactional tax issues, with articles that include "Partnership Bankruptcy Tax issues," "Debt Exchanges," "Bankruptcy Tax Issues," and "Bankruptcy Tax 101." She also authors the chapters on Debt Exchanges in *Collier on Bankruptcy Taxation* (Matthew Bender) and Securities Lending Transactions in *Taxation of Financial Institutions* (Clark Boardman Callaghan). In addition to writing, she speaks on a broad range of topics, including each year on workout and bankruptcy tax issues at the corporate and real estate tax PLI conferences.

Linda is a member of the Executive Committee of the New York State Bar Association Tax Section and has chaired its Tax-Free Reorganizations; Corporations; Bankruptcy; Consolidated Returns; Real Property; and Tax Accounting and Basis Committees.

Linda received her J.D. from University of Pennsylvania Law School, and her B.A. from Bucknell University, where she graduated *magna cum laude* and was elected to Phi Beta Kappa.

CONSEQUENCES OF DEEMED EXCHANGES

Issuer Consequences of Deemed Exchanges

Issuer realizes COD to extent issue price of new debt is less than issue price of old debt.

- **Publicly Traded Debt.** COD income if trading price of new debt is less than adjusted issue price of old debt, including, for example, for a borrower seeking a loan modification despite no change in the amount or timing of principal due, e.g., a yield change.
- **Other Debt.** If new debt has adequate stated interest, COD income is only realized if principal is reduced.

Holder Consequences of Deemed Exchanges

Holders generally recognize taxable gain or loss.

- **Publicly Traded Debt.** If either old debt or new debt is “publicly traded,” measure gain or loss by FMV of debt over holder’s adjusted tax basis. Market discount is transformed into OID.
- **Other Debt.** No gain or loss to original holder if new fixed rate debt bears “adequate stated interest,” and principal amount is not reduced. If new debt lacks “adequate stated interest,” gain or loss is measured by FMV of new debt over adjusted tax basis. Secondary purchasers recapture market discount as ordinary income.

If a deemed exchange is a recapitalization, no gain or loss to holders.

HOLDER CONSEQUENCES

Holder Consequences of All Deemed Exchanges

Whether or not a taxable exchange, a deemed issuance of new debt raises holder issues.

- Market discount becomes OID, requiring current income accruals going forward.
- New participating debt may not qualify for the portfolio interest exception and may subject foreign holders to FIRPTA.
- New debt may constitute an AHYDO, which would limit the issuer's deductions for substantial OID and raise cash flow issues.
- Requires retest of debt/equity; significant issues if new debt is equity.

Holder Consequences of Tax-Free Deemed Exchanges

Tax-free recapitalization – corporations only.

- Must exchange tax securities for tax securities.
- Most important tax security characteristic is the debt's original term to maturity.
- Historically, term of 5 years or less was not a security, 5 to 10 year term was uncertain, and a 10 year term was a security. However, the IRS has tacked the original maturity of exchanged debt, allowing recap treatment for new short maturity debt issued in a workout. See Rev. Rul. 2004-78.

Tax-free partnership debt for equity exchanges are governed by separate rules. See Prop. Reg. §§ 1.108-8; 1.721-1.

Matching Deferred COD and OID

- Gain/loss equals difference between holder's basis in old debt and issue price of new debt.
- If either old or new debt is publicly traded, issue price of new debt is the FMV of the traded debt.
- Exchange of publicly traded debt may result in capital loss and OID income on new debt for holders.
- If neither debt is publicly traded and the new debt bears adequate interest, issue price generally equals the new debt's principal amount.
- Exchange of nonpublicly traded debt can result in significant noneconomic gain for distressed debt buyers because issue price equals principal amount if tax basis is low due to recent purchase.

CONSEQUENCES OF DEBT EXCHANGES FOR DIFFERENT TYPES OF HOLDERS

For U.S. Banks

Banks can claim bad debt deductions with or without exchange, so generally indifferent to exchanges.

- Conformity election for bad debts.
 - All gain and loss is ordinary.
 - Deemed charge off if debt exchange creates phantom gain.
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For REITs and RICs

- Income on taxable exchanges may affect distribution requirements, as amended by the CARES Act.
 - RICs may not receive good income if debt is recharacterized as partnership equity.
 - REITs need to confirm that any rents received, and interest on participating debt, will qualify as good income under REIT rules.
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For Foreign Holders

Exchange is not taxable unless old debt is held in connection with a U.S. trade or business, or FIRPTA applies.

- Foreign funds that buy and sell distressed debt slated for workouts may be treated as engaged in a U.S. trade or business unless strict guidelines are satisfied.
 - If new debt is participating debt, portfolio interest exception will not be available and FIRPTA may apply.
 - If new debt is partnership equity, future income on debt, and other lender income, may be ECI. FIRPTA may also apply to sales of deemed partnership equity interests.
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For U.S. Tax-Exempt Holders

Unless old debt was debt financed, exchange is not taxable.

If new debt is partnership equity, need to consider UBTI.

- For rents to qualify under section 512(b)(3):
 - No non-customary services;
 - No participation other than a fixed percentage of receipts or sales; and
 - Not too much personal property.
- If there is underlying debt, section 514(c)(9) should be investigated.